No. 8166

In the United States Circuit Court of Appeals for the Ninth Circuit

PACIFIC EMPLOYERS INSURANCE COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 33–39), which is reported in 33 B. T. A. 501.

JURISDICTION

The petition for review involves a deficiency in income taxes for the year 1930 in the amount of $1,193.45 and is taken from a decision of the Board of Tax Appeals entered November 21, 1935 (R. 40).

The case is brought to this Court by a petition for review filed February 17, 1936 (R. 40–47), pursuant to the provisions of Sections 1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109–110, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169, 286.

QUESTION PRESENTED

Whether the deduction permitted insurance companies OTHER THAN LIFE OR MUTUAL by Section 204 (c) of the Revenue Act of 1928, for "losses incurred" as defined by Section 204 (b) (6) of that Act, includes so-called reserves required to be maintained by state law on account of workmen's compensation and liability insurance contracts written.

STATUTES AND REGULATIONS INVOLVED

These are set forth in the appendix, *infra,* pp. 20–30.

STATEMENT

The facts in the case were stipulated (R. 20–26), and as stipulated, were adopted by the Board of Tax Appeals as its findings of fact (R. 33).

So far as deemed material, the facts may be briefly stated as follows:

The petitioner is an insurance company other than life or mutual, organized under, and subject to, the laws of the State of California. Its business, which is confined solely to that State, is operated under a Certificate of Authority issued by the Insurance Commissioner of California (R. 21).

During the tax year 1930, approximately 14/15 of petitioner's net premium income was derived from workmen's compensation insurance; the balance was derived from automobile liability, collision, and property damage insurance, and from public liability and theft insurance (R. 22).

Petitioner, in making its income tax return for the calendar year 1930, claimed as a deduction for "losses incurred" the sum of $882,632.55 computed as follows (R. 22, VIII):

Losses paid		$865,801.55
End (losses unpaid at end of 1930) 1930	$660,980.00	
End (losses unpaid at end of 1929) 1929	644,149.00	16,831.00
Losses incurred		$882,632.55

It is undisputed that respondent allowed as a deduction from petitioner's gross income said item of $865,801.55 as "losses paid" plus the difference between "losses unpaid" of $660,980.00 at the end of the year 1930, and "losses unpaid" of $644,149.00, at the end of the year 1929, or $16,831.00 making the total deduction allowed for "losses incurred" $882,632.55.

This amount claimed by the petitioner as a deduction in its 1930 return and allowed by the respondent was the result of a careful examination based on claims actually filed with petitioner (R. 24).

Of the total of $660,980.00, above stated, the sum of $60,884.00 related to liability claims and the balance of $600,096.00 related to workmen's com-

pensation claims. Of the total of "losses unpaid" $644,149.00 at the end of 1929, the sum of $41,491.00 related to liability claims and the balance of $602,658.00 related to workmen's compensation claims (R. 22–23).

These "losses unpaid" at the end of the respective years 1929 and 1930 were determined from estimates made by petitioner's Claims Examiner as to the ultimate cost of the final adjustment of each outstanding claim. In making such estimates, the Claims Examiner took into consideration a number of elements which might affect the ultimate cost of adjustment, and the totals, as revised from time to time, represented the sums respectively claimed by petitioner in its 1930 return as "losses unpaid" at the end of the years 1929 and 1930 (R. 23–24).

At the time of filing its 1930 income tax return, petitioner attached thereto and filed therewith a copy of portions of its annual statement for the year 1930 as filed wih the Insurance Commissioner for the State of California on a form designated "Miscellaneous Stock Companies — Convention Edition 1930", approved by the National Convention of Insurance Commissioners referred to in subparagraph (b) (1) of Section 204 of the Revenue Act of 1928 (R. 24–25).

On page 8 of said annual statement (R. 30) is set forth petitioner's "Underwriting and Investment Exhibit" showing the sources of the increase and

decrease of petitioner's surplus during the year 1930. On line 10 of this exhibit (R. 30) is shown the item of $865,801.55 representing the deduction claimed by petitioner and allowed for "losses paid" during the year 1930. On line 11 thereof (R. 30) is shown an item of $596,532.85 described therein as "unpaid losses December 31 of current year, per item 19, page 5." On page 5 of the annual statement (R. 29) petitioner's "Liabilities" are set forth and said item 19 thereof shows "Total unpaid claims—$596,532.85" including—

Line 15 (6): Total net unpaid claims except liability and workmen's compensation claims (excluding expenses of investigation and adjustment)		$8,290.00
Line 16: Reserve for—		
Unpaid liability losses	$33,879.10	
and		
Workmen's Compensation losses	554,363.75	
		588,242.85
Total unpaid claims [end of 1930]		596,532.85

On line 13 of the "Underwriting and Investment Exhibit" (R. 30) is shown an item of $440,318.52 described therein as "unpaid losses December 31 of previous year [1929], per item 15 of last year's exhibit" which concededly was computed on the same basis as said item of $596,532.85.

It has been stipulated (R. 25, X) that said items $596,532.85 and $440,318.52, respectively, were computed in accordance with the provisions of Section 602 (a) of the Political Code of California, and represents the highest aggregate reserve, after deduction for reinsurance, called for at the beginning

and end of the taxable year (1930) by the laws of the State of California, and represents reserves actually held by petitioner at the beginning and end, respectively, of the year 1930.

Petitioner contended before the Board of Tax Appeals that it was entitled to deduct from its 1930 gross income under the provisions of Section 204 (c) (4) of the Revenue Act of 1928 as "losses incurred" the difference between said items of $596,532.85 and $440,318.52, or $156,214.33, on the ground that said items constituted, within the meaning of Section 204 (b) (6) of the Act "unpaid losses outstanding at the end of 1930" and "unpaid losses outstanding at the end of the preceding taxable year", respectively.

Respondent contended that said items constituted reserves for unpaid losses which petitioner, under the laws of California, was required to maintain and not "losses incurred" within the meaning of Section 204 (c) (4) of the Revenue Act of 1928. The Board of Tax Appeals sustained respondent's position and held that insurance companies other than life or mutual, writing workmen's compensation and liability insurance, may not take as a deduction for "unpaid losses" a reserve based on the amount of the company's earned workmen's compensation and liability insurance premiums.

The case is here upon the petitioner's petition for review.

SUMMARY OF ARGUMENT

Insurance companies other than life or mutual may not deduct, under the provisions of Section 204 (c) (4) of the Revenue Act of 1928, as "losses incurred" the net additions made during the year to so-called reserves required by state law on account of liability and workmen's compensation insurance contracts written.

Prior to the enactment of the Revenue Act of 1921, insurance companies were permitted to deduct from gross income "the net addition, if any, to reserve funds required by law." That deduction was eliminated by Congress in the case of insurance companies other than life or mutual in the Revenue Act of 1921 and in all subsequent Revenue Acts. Nowhere in the Revenue Act of 1928 is there any provision for the deduction of any reserve in the case of companies of the type here in question.

The statutory provision for the use of the underwriting and investment exhibit referred to in Section 204 (b) (1) of the 1928 Act is limited to the determination of gross income. It is not referred to either directly or indirectly in the provisions of Section 204 (c) of the Act and it is therefore not essential in the determination of a deduction for "losses incurred" provided by Section 204 (c) (4) of the Act.

The deductions granted by respondent in this case for "losses incurred" are in accord with the

statute and the regulations and rulings promulgated thereunder by respondent.

ARGUMENT

I

THE DEDUCTION PERMITTED INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL BY SECTION 204 (c) (4) OF THE REVENUE ACT OF 1928, FOR "LOSSES INCURRED", AS DEFINED BY SECTION 204 (b) (6) OF THE ACT DOES NOT INCLUDE SO-CALLED RESERVES REQUIRED TO BE MAINTAINED BY STATE LAW ON ACCOUNT OF WORKMEN'S COMPENSATION AND LIABILITY INSURANCE CONTRACTS WRITTEN

Since petitioner is neither a life nor a mutual insurance company it is taxable for the year 1930 as an insurance company other than life or mutual under the provisions of Section 204 of the Revenue Act of 1928, *infra*, p. 20.

That Act specifically defines the gross and net income of the type of insurance companies taxable thereunder, as well as the meaning of the terms "underwriting income", "premiums earned", "expenses incurred", "losses incurred", etc.

The deduction here in controversy is granted by Congress in Section 204 (c) (4), reading as follows:

> (c) *Deductions allowed.*—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:
>
> * * * (4) Losses incurred as defined in subsection (b) (6) of this section; * * *.

The meaning of the term "losses incurred" is defined in subsection (b) (6) as follows:

(b) *Definition of income, etc.*—In the case of an insurance company subject to the tax imposed by this section—

* * * (6) LOSSES INCURRED.—"Losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year; * * *.

Petitioner, in making its 1930 income tax return, claimed, and was granted, as a deduction for "losses incurred", a total of $882,632.55 made up of losses actually paid during the year amounting to the sum of $865,801.55 plus the sum of $16,831.00, representing the difference between the sum of $644,149.00 and the sum of $660,980.00 claimed by petitioner as "losses unpaid" at the end of the respective years 1929 and 1930 (R. 22, VIII).

It has been stipulated that the above "losses unpaid" were computed upon claims *actually filed* with petitioner and upon the basis of estimates "of the ultimate cost of final adjustment of each outstanding unadjusted claim made by a Claim

Examiner", the total, as revised from time to time, being the sum of such estimates on each such claim (R. 22–24).

The deductions granted by respondent were computed upon the basis of losses actually paid during the year 1930 and upon the basis of "losses unpaid" upon claims actually accrued and outstanding at the end of the respective years 1929 and 1930, and they were therefore properly allowed by respondent. See *Ocean Accident & G. Corp.* v. *Commissioner,* 47 F. (2d) 582 (C. C. A. 2d).

We come now to the sole controversy in this case, i. e., petitioner's contention that it is entitled to include in the deduction for "losses incurred" as "losses unpaid" the net addition to reserves held by petitioner at the beginning and end of the year 1930 in the respective amounts of $440,318.52 and $596,532.85 (R. 26, XI).

These so-called reserves were admittedly required to be held by petitioner, and were computed, under the provisions of Section 602 of the Political Code of California, *infra*, p. 25, and represented, respectively, "the highest Aggregate Reserve, after deduction for reinsurance, called for at the beginning and end of the taxable year by said law of said State of California" (R. 25–26).

Petitioner would thus include in the deduction for "losses incurred" granted by Section 204 (c) (4) of the Act, the difference being its reserves for

so-called unpaid losses held at the beginning and end of the year 1930, or the sum of $156,214.33, and would thereby increase the deduction for "losses incurred" during the year 1930 from the sum of $882,632.55, claimed in its 1930 return and allowed by respondent, to the sum of $1,022,015.88 (R. 26), or a net increase in the deduction for "losses incurred" of $139,383.33.

It is undisputed that petitioner's so-called reserves were computed under the provisions of said Section 602 (a) of the Political Code of California upon the basis of earned premiums not only for the tax year 1930, but also for prior years, on its liability and workmen's compensation insurance contracts written and outstanding. See supporting schedules (R. 31–32).

It is established that the income tax laws require, unless otherwise specifically provided by statute, that the net income of a taxpayer for each year must stand by itself. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359.

Here it clearly appears that petitioner's so-called reserves are based upon average earned premiums of several years and not upon the basis of earned premiums for the tax year 1930. If petitioner were permitted to change the method of computing "unpaid losses" from the actual outstanding accrued loss method reflected in its 1930 return to the average reserve method for which it is now contending, a distortion of petitioner's true taxable

net income for the tax year 1930 would, we submit, inevitably result, contrary to the principles announced by the Supreme Court in the *Sanford & Brooks Co.* case, *supra.*

(a) *A taxpayer is not entitled as a matter of right to any deductions from gross come.*

It has been established by repeated decisions of the Supreme Court that a taxpayer is not entitled as a matter of right to any deductions from gross income but may claim only such deductions as are specifically authorized by statute. *Burnet* v. *Thompson Oil & G. Co.,* 283 U. S. 301; *Helvering* v. *Inter-Mountain Insurance Co.,* 294 U. S. 686; *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364.

The deductions from gross income granted by Congress to insurance companies other than life or mutual by the Revenue Act of 1928 are listed in detail in Section 204 (c), subparagraphs 1 to 10, inclusive, *infra.* There are no provisions therein contained for the deduction by such companies of an insurance reserve of any kind.

This is particularly significant since, in the preceding Section 203, pertaining to life companies, as well as in the succeeding Section 208, pertaining to mutual insurance companies, there are expressly set forth provisions for the deduction of reserve funds required by law in the case of these companies. The omission was deliberate. Prior to the enactment of the Revenue Act of 1921, all in-

surance companies were permitted to deduct from gross income "the net addition, if any, to reserve funds required by law."[1] That deduction was eliminated by Congress, however, in the case of insurance companies other than life or mutual in the Revenue Act of 1921 and in all subsequent Revenue Acts. Nowhere in the Revenue Act of 1928, as already stated, is there any provision for the deduction of any reserve in the case of companies of the type here in question, in view of which, the deduction now claimed by petitioner must be denied even though the amounts held by petitioner at the beginning and end of the tax year 1930 are required to be held as so-called reserves under the laws of the State of California. *American Title Co.* v. *Commissioner,* 76 F. (2d) 332, 333 (C. C. A. 3d); *Ocean Accident & G. Corp.* v. *Commissioner, supra;* compare *United States* v. *Boston Insurance Co.,* 269 U. S. 197.

II

THERE IS NO PROVISION IN THE STATUTE REQUIRING THAT THE DEDUCTIONS GRANTED BY CONGRESS IN SECTION 204 (C) SHALL BE COMPUTED ON THE BASIS OF THE UNDERWRITING AND INVESTMENT EXHIBIT OF THE ANNUAL STATEMENT APPROVED BY THE NATIONAL CONVENTION OF INSURANCE COMMISSIONERS

Petitioner contends (Br. 20–26) that since the deduction for "losses incurred" as defined by Sec-

[1] Act of August 5, 1909, c. 6, 36 Stat. 11, 113, Sec. 38 (Second); Act of October 3, 1913, c. 16, 38 Stat. 114, 172–173, Sec. II G (b) (Second); Revenue Act of 1916, c. 463, 39 Stat. 756, 767–768, Sec. 12 (a) (Second) (c); Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077–1079, Sec. 234 (a) (10).

tion 204 (b) (6), *supra,* includes "unpaid losses", such "unpaid losses" must be computed on the basis of the underwriting and investment exhibit (R. 30) attached to its annual statement (Convention Edition) to the Insurance Commissioner of the State of California. Petitioner's contention is based upon the fact that Section 204 (b) (1) of the Act, *infra,* p. 20, provides that the gross income of an insurance company other than life or mutual is to be "computed on basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners" and from this it is argued that the deduction for "losses incurred" including "unpaid losses" must be computed on the same basis.

In this connection, the attention of the Court is invited to the following statement made by the petitioner (Br. 26):

> Since the respondent has stipulated that upon the basis of the "underwriting and investment exhibit", the amount of "losses incurred" was $1,022,015.88 [Tr. 24–26] and the law expressly requires that exhibit to be followed, the Board clearly erred in allowing a lesser deduction computed under a method prescribed in the law.

No such concession, as disclosed by the record herein, was ever made by respondent and, we submit, that no such concession can be drawn from

the facts stipulated at pages 24 to 26 of the record as contended by petitioner.

All that was stipulated was that the exhibits in evidence (R. 27–32) were correct copies of petitioners' annual statement to the Insurance Commissioner of California on forms approved by the National Convention of Insurance Commissioners referred to in said subparagraph (b) (1) of Section 204. The inference which petitioner seeks to convey is, we submit, wholly unwarranted by the facts stipulated.

It is respondent's position that the statutory provision for the use of the underwriting and investment exhibit referred to in said Section 204 (b) (1) is limited to the determination of petitioner's gross income. It is not referred to either directly or indirectly in the provisions of Section 204 (c) of the Act and is therefore not essential, we submit, in the determination of the deduction for "losses incurred" provided by Section 204 (c) (4), *supra.*

In the case of *Home Title Ins. Co.* v. *United States,* 50 F. (2d) 107 (C. C. A. 2d), the Government contended, under the corresponding provisions of Section 246 (b) (1) of the Revenue Acts of 1921 and 1924, that since the National Convention of Insurance Commissioners had not approved a form for an underwriting and investment exhibit in the case of title insurance companies, Congress must have intended to tax such companies as ordinary corporations and not as insur-

ance companies other than life or mutual. In disposing of the Government's contention, the court said (p. 111):

> Although section 246 (b) (1) refers to the form of annual statement approved by the National Convention of Insurance Commissioners, other subdivisions of the section proceed to specify how gross and net income are to be computed, so that the absence of such an approved form of annual statement would seem unimportant. See *Massachusetts Protective Ass'n* v. *Commissioner,* 18 B. T. A. 810; *Western Casualty Co.* v. *Commissioner,* 20 B. T. A. 738.

See also, *American Title Co.* v. *Commissioner,* 29 B. T. A. 479, 480.

In addition to the above, there is, however, another complete answer to petitioner's contention that its underwriting and investment exhibit is controlling here as to the amount of "unpaid losses" shown thereon in lines 11 and 13, respectively (R. 30). It is true that said items of $596,532.85 and $440,318.52 here in controversy are shown on said underwriting and investment exhibit as "unpaid losses", but reference to item 19, page 5 (R. 29) referred to in line 11 will show that the item of $596,532.85 is, in fact, the reserve which petitioner is required to compute and maintain under the provisions of said Section 602 (a) of the Political Code of California.

It is not disputed that the item of $440,318.52 was precisely the same character.

It is clear, we submit, that petitioner is here seeking a deduction based not upon "unpaid losses" accrued and outstanding at the beginning and end of the year 1930, but a deduction for the net addition to the reserve funds which it was required to hold at the beginning and end of the tax year 1930 under the laws of the State of California, a deduction to which it is clearly not entitled under the provisions of the Revenue Act of 1928. *American Title Co.* v. *Commissioner,* 76 F. (2d) 332, 333, *supra.*

III

THE DEDUCTIONS GRANTED BY RESPONDENT IN THIS CASE FOR "LOSSES INCURRED" ARE IN ACCORD WITH THE STATUTE AND WITH THE REGULATIONS AND RULINGS PROMULGATED THEREUNDER BY RESPONDENT

Petitioner contends (Br. 27–31) that the regulations and rulings of the respondent have consistently interpreted the law as requiring the computation of "losses incurred" including "unpaid losses" upon the basis of the underwriting and investment exhibit set forth in the form approved by the National Convention of Insurance Commissioners commonly referred to as the "Convention Edition."

We have already pointed out, however, that the presence or absence of such underwriting and investment exhibit is not controlling in the computation of the net income of an insurance company other than life or mutual. *Home Title Ins. Co.* v. *United States, supra; America Title Co.* v. *Commissioner,* 29 B. T. A. 479, *supra.*

It is true that Article 692 of Regulations 62, promulgated in connection with the 1921 Act contained the express provision that "the underwriting and investment exhibit is presumed clearly to reflect the true net income of the company and in so far as it is not inconsistent with the provisions of the statute will be recognized and used as a basis for that purpose."

It is also true that this identical provision was carried forward as Article 692 of Regulations 65 and 69, promulgated under the provisions of the respective Revenue Acts of 1924 and 1926, and as Article 992 of Regulations 74 pertaining to the Revenue Act of 1928, *infra*, p. 20, but it will be noted that the underwriting and investment exhibit is presumed to reflect the true net income only in so far as it is not inconsistent with the provisions of the statute.

The statute here, as we have already shown, does not permit petitioner to deduct from its 1930 gross income the net addition to its reserve funds required by the laws of the State of California and must therefore be held to overcome any presumption that said underwriting and investment exhibit reflects petitioner's true net income.

Petitioner relies upon G. C. M. 2318, VI–2 Cumulative Bulletin 80, set forth in petitioner's brief as Appendix A. It will be noted that that opinion deals with the deductions claimed by a fire insurance company for "losses incurred but not re-

ported" and "resisted losses." Clearly, "losses incurred but not reported" constitute accrued liabilities of the company and as such they were clearly deductible as "losses incurred." Compare *New York Life Ins. Co.* v. *Edwards,* 271 U. S. 109, 119. Clearly, also, "resisted losses" also constituted accrued liabilities of the company and as such they were likewise deductible as "losses incurred." *Ocean Accident & G. Corp.* v. *Commissioner, supra.*

The items which petitioner is here seeking to include as "unpaid losses", however, were not *accrued losses* but, as stipulated (R. 26), represented "the highest Aggregate Reserve, after deduction for reinsurance, called for at the beginning and end of the taxable year by said law of said State of California." As such, no part thereof constituted deductible "losses incurred" within the meaning of the Revenue Act of 1928.

CONCLUSION

It is respectfully submitted that the decision of the Board of Tax Appeals should be affirmed.

Respectfully submitted.

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OCTOBER 1936.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 204. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.—

(a) *Imposition of tax.*—In lieu of the tax imposed by section 13 of this title, there shall be levied, collected, and paid for each taxable year upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company, 12 per centum of its net income;

(2) In the case of such a foreign insurance company, 12 per centum of its net income from sources within the United States.

(b) *Definition of income, etc.*—In the case of an insurance company subject to the tax imposed by this section—

(1) GROSS INCOME.—"Gross income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the bases of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property;

(2) NET INCOME.—"Net income" means the gross income as defined in paragraph (1) of this subsection less the deductions allowed by subsection (c) of this section.

(3) INVESTMENT INCOME.—"Investment income" means the gross amount of income

earned during the taxable year from interest, dividends, and rents, computed as follows:

To all interest, dividends, and rents received during the taxable year, add interest, dividends, and rents due and accrued at the end of the taxable year, and deduct all of interest, dividends, and rents due and accrued at the end of the preceding taxable year;

(4) UNDERWRITING INCOME.—"Underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) PREMIUMS EARNED.—"Premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To this result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

(6) LOSSES INCURRED.—"Losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) EXPENSES INCURRED.—"Expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by subsection (c) of this section.

(c) *Deductions allowed.*—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in section 23 (a);

(2) All interest as provided in section 23 (b);

(3) Taxes as provided in section 23 (c);

(4) Losses incurred as defined in subsection (b) (6) of this section;

(5) Losses sustained during the taxable year from the sale or other disposition of property;

(6) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(7) The amount received as dividends from corporations as provided in section 23 (p);

(8) The amount of interest earned during the taxable year which under section 22 (b) (4) is exempt from taxation under

this title, and the amount of interest allowed as a credit under section 26;

(9) A reasonable allowance for the exhaustion, wear and tear of property, as provided in section 23 (k);

(10) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $3,000; but if the net income is more than $25,000 the tax imposed by this section shall not exceed the tax which would be payable if the $3,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(d) *Deductions of foreign corporations.*—In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in Supplement I.

(e) *Double deductions.*—Nothing in this section shall be construed to permit the same item to be twice deducted.

Regulations 74, promulgated by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, in accordance with the provisions of the Revenue Act of 1928, provides by Articles 991, 992, and 993 as follows:

ART. 991. *Tax on insurance companies other than life or mutual.*—For the calendar year 1928 and subsequent years all insurance companies (other than life or mutual companies) are subject to the tax imposed by section 204. Mutual insurance companies (other than life) remain subject to the tax imposed by section 13. The term "insurance companies" as used in this article and in articles 992 and 993 means only those companies subject to the tax imposed by section 204. The rate of the tax imposed by section

204 is 12 per cent, and the net income upon which the tax is imposed, as defined in section 204, differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 117 (net losses) but not of section 101 (capital gains and losses). All provisions of the Act and of these regulations not inconsistent with the specific provisions of section 204 are applicable to the assessment and collection of this tax, and insurance companies are subject to the same penalties as provided in the case of returns and payment of income tax by other corporations. Since section 204 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the first returns under section 204 will be for the taxable year ending December 31, 1928.

ART. 992. *Gross income of insurance companies other than life or mutual.*—Gross income as defined in section 204 (b) means the gross amount of income earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, as well as the gain derived from sale or other disposition of property. It does not include increase in liabilities during the year on account of reinsurance treaties, remittances from the home office of a foreign insurance company to the United States branch, borrowed money, gross increase due to adjustments

in book value of capital assets, and premium on capital stock sold. The underwriting and investment exhibit is presumed clearly to reflect the true net income of the company, and in so far as it is not inconsistent with the provisions of the Act will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the Act. By reason of the definition of investment income, miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared, home office remittances and receipts, and special deposits, are ignored. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been charged off the books of the company as bad debts or, having been previously charged off, are recovered during the taxable year.

ART. 993. *Deductions allowed insurance companies other than life or mutual.*—The deductions allowable are specified in section 204, and include losses sustained from the sale or other disposition of property. * * *

Political Code of California, Title I, Chapter 3, Part III, Article 16, Section 602 (a):

602 (a). *Liabilities of Insurance companies.—Computation of reserve.*—In estimating the condition of any insurance corporation, mutual company, association, the state compensation insurance fund, inter-insurance exchange, or other insurance carriers engaged in the business of liability insurance and licensed to transact business

in this state, the insurance commissioner shall charge as liabilities, all outstanding indebtedness of such carrier, and the premium reserve on policies in force, equal to the unearned portions of the gross premiums charged for covering the risks, computed on each respective risk from the date of the issuance of the policy.

The reserve for outstanding losses under insurance against loss or damage from accident to or injuries suffered by an employee or other person and for which the insured is liable shall be computed as follows:

(1) *Liability suits.*—For all liability suits being defended under policies written more than—

(a) Ten years prior to the date as of which the statement is made, one thousand five hundred dollars for each suit.

(b) Five and less than ten years prior to the date as of which the statement is made, one thousand dollars for each suit.

(c) Three and less than five years prior to the date as of which the statement is made, eight hundred fifty dollars for each suit.

(2) *Liability policies.—For all liability policies* written during the three years immediately preceding the date as of which the statement is made, *such reserve shall be sixty per centum of the earned liability premiums of each of such three years less all loss and loss expense payments made under the liability policies written in the corresponding years;* but in any event, such reserve shall for the first of such three years, be not less than seven hundred fifty dollars for each outstanding liability suit on said year's policies.

(3) *Claims under policies written three years prior.*—For all compensation claims under policies written more than three years prior to the date as of which the statement is made, the present values at four per centum interest of the determined and the estimated future payments.

(4) *Claims under policies written three years preceding.—For all compensation claims* under policies written in the three years immediately preceding the date as of which the statement is made, *such reserve shall be seventy per centum of the earned compensation premiums of each of such three years, less all loss and loss expense payments made in connection with such claims under policies written in the corresponding years;* but in any event in the case of the first year of any such three-year period such reserve shall be not less than the present value at four per centum interest of the determined and the estimated unpaid compensation claims under policies written during such year.

"*Earned premiums.*"—The term "earned premiums", as used herein, shall include gross premiums charged on all policies written, including all determined excess and additional premiums, less return premiums, other than premiums returned to policyholders as dividends, and less reinsurance premiums and premiums on policies canceled, and less unearned premiums on policies in force.

"*Compensation.*"—The term "compensation" as used in this act shall relate to all insurance effected by virtue of statutes providing compensation to employees for personal injuries irrespective of fault of the employer. The term "liability" shall relate to all insurance except compensation insur-

ance against loss or damage from accident to or injuries suffered by an employee or other person and for which the insured is liable.

"*Loss payments.*"—The terms "loss payments", and "loss expense payments", as used herein, shall include all payments to claimants, including payments for medical and surgical attendance, legal expenses, salaries, and expenses of investigators, adjusters and field men, rents, stationery, telegraph and telephone charges, postage, salaries and expenses of office employees, home office expenses, and all other payments made on account of claims, whether such payments shall be allocated to specific claims or unallocated.

Distribution of unallocated liability loss expense payments.—All unallocated liability loss expense payments made in a given calendar year subsequent to the first four years in which an insurer has been issuing liability policies, shall be distributed as follows: Thirty-five per centum shall be charged to the policies written in that year, forty per centum to the policies written in the preceding year, ten per centum to the policies written in the second year preceding, ten per centum to the policies written in the third year preceding, and five per centum to the policies written in the fourth year preceding, and such payments made in each of the first four calendar years in which an insurer issues liability policies shall be distributed as follows: In the first calendar year one hundred per centum shall be charged to the policies written in that year, in the second calendar year fifty per centum shall be charged to the policies written in that year and fifty per centum to the policies written in the preceding year; in the third

calendar year forty per centum shall be charged to the policies written in that year, forty per centum to the policies written in the preceding year, and twenty per centum to the policies written in the second year preceding, and in the fourth calendar year thirty-five per centum shall be charged to the policies written in that year, forty per centum to the policies written in the preceding year, fifteen per centum to the policies written in the second year preceding, and ten per centum to the policies written in the third year preceding, and a schedule showing such distribution shall be included in the annual statement.

Distribution of unallocated compensation loss expense payments.—All unallocated compensation loss expense payments made in a given calendar year subsequent to the first three years in which an insurer has been issuing compensation policies shall be distributed as follows: Forty per centum shall be charged to the policies written in that year, forty-five per centum to the policies written in the preceding year, ten per centum to the policies written in the second year preceding, and five per centum to the policies written in the third year preceding, and such payments made in each of the first three calendar years in which an insurer issues compensation policies shall be distributed as follows: In the first calendar year one hundred per centum shall be charged to the policies written in that year, in the second calendar year fifty per centum shall be charged to the policies written in that year and fifty per centum to the policies written in the preceding year, in the third calendar year forty-five per centum shall be charged to the policies written in that year, forty-five per centum to the policies written

in the preceding year and ten per centum to the policies written in the second year preceding, and a schedule showing such distribution shall be included in the annual statement.

Additional reserves.—Whenever, in the judgment of the insurance commissioner, the liability or compensation loss reserves of any insurer under his supervision, calculated in accordance with the foregoing provisions, are inadequate, he may, in his discretion, require such insurer to maintain additional reserves based upon estimated individual claims or otherwise.

Schedule of experience.—Each insurer that writes liability or compensation policies shall include in the annual statement required by law a schedule of its experience thereunder in such form as the insurance commissioner may prescribe. (Amendment approved May 26, 1917; Stats. 1917, p. 1178.) [Italics Supplied.]

[History.—Amendment approved June 6, 1913, Stats. and Amdts. 1913, p. 493; amended May 26, 1917, Stats. and Amdts. 1917, p. 1178. In effect July 27, 1917.]

[Editorial note.—On June 6, 1913, two acts were passed amending Sec. 602a, see Stats. and Amdts. 1913, pp. 465, 493, Kerr's Cumulative Supplement to Cyc. Codes of California, 1906–1913, pp. 65–70, and "editorial" note on pp. 67, 68. From a reading of the two amendments of 1903 it is manifest that the intention of the legislature was to amend the second of the acts passed on June 6, 1913, and which in "Kerr's Cumulative Supplement" and "Kerr's Small Codes of California", is designated as Sec. 602 (a). In case of any doubt consult those works.]

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